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TRUSTS UNDER THE NEW CODE WHERE THE GRANTOR IS TREATED AS THE SUBSTANTIAL OWNER

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The provisions of Section 671 to 678 of the Internal Revenue Code of 1954 prompt a re-examination of the tax consequences of so-called short term trusts and other trusts. It is believed that heretofore many competent lawyers have shied away from recommending to their clients the creation of short term trusts, largely because of the wide range of uncertainties surrounding the principles under which the grantors of such trusts have been taxable. To a considerable degree, many of these uncertain elements have been removed, and it behooves lawyers once more to re-examine the possibilities of income tax savings for their clients by the use of the short term trust and other trusts.

I. Preliminary Considerations

A. WHAT IS A SHORT TERM TRUST?

There are several elementary inquiries to be made. First of all, there is the question of what is meant by a short term trust. The term is a minimum of ten years. More specifically, the term of the trust is one in which the reversionary interest of the grantor in either the corpus or the income from the trust will not or may not reasonably be expected to take effect in possession or enjoyment within ten years.[1] Even more specifically, the ten year term commences with the inception of the trust, or with the date of the transfer to the trust of any portion of the trust which becomes subject to the applicable sections of the Code. There is, however, a provision that the grantor of such a short term trust will not be treated and taxed as the owner where his reversionary interest might take effect in possession or enjoyment upon the death of the income beneficiary.[2] The Senate Committee Report[3] explains that this exception is applicable even though, due to the short life expectancy of the beneficiary, the grantor's reversionary interest may reasonably be expected to take effect within ten years.

B. WHY A SHORT TERM TRUST?

Another preliminary inquiry is: why should any one be in-

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[1] Section 673(a). Unless otherwise indicated, reference to sections in the footnotes refers to sections of the Internal Revenue Code of 1954.

[2] Section 673(c).

[3] Sen. Rep. No. 1622, 83d Cong., 2d Sess. 367 (1954).

terested in creating a trust for less than ten years? One need only look at the rates of tax on individuals in the first section of the Code to come to a rapid realization of the benefits of having income distributed among members of a family who are in lower tax brackets. While an outright gift might afford similar tax advantages, the short term trust preserves a certain element of eventual re-enjoyment or re-control which is lacking in the finality of an absolute and outright gift. Even the possibilities of accumulation of income in a lower tax bracket is enticing, although this phase of the subject matter must be scrutinized with special care in the light of the so-called "throw back" rule in the new Code.[4] It should be observed, however, that the "throw back" rule does not necessarily make short term trusts for accumulation of income wholly unattractive.[5]

Numerous examples may be given to illustrate situations where short term trusts are attractive. They may provide a means for setting aside an educational fund for minor children or grandchildren, or for providing a fund for them in the years immediately following their attainment of legal age when the fund would be helpful in starting a business or establishing a home. They might be used to create a fund for use in payment of estate taxes. A short term trust might advantageously be used to provide for the support of an elderly relative legally dependent on the grantor or toward whom the grantor feels a moral obligation. There are innumerable possibilities in connection with life insurance, such as a fund for the payment of insurance premiums. These are but a few of the situations where short term trusts afford possibilities for effective planning.

C. ESTATE AND GIFT TAX CONSEQUENCES OF SHORT TERM TRUSTS

Still another preliminary inquiry concerns the estate and gift tax consequences of short term trusts. It is true that if the grantor dies before the trust terminates, the value of his reversionary interest is subject to estate tax in the grantor's estate.[6] This should not, howevver, foreclose consideration of short term trusts. It is submitted that one should not have to wait until death to have an orderly and efficient administration of his affairs. Planning has attractions which are possible for the affairs of a living person, as well as for his beneficiaries. It would seem that many persons would welcome suggestions to reduce their own income tax, even though their estate tax may be increased. And even for the person who is concerned only with benefits which may accrue

[4] Sections 2501 to 2504.
[5] See exceptions listed in § 665(b).
[6] Section 2033.

to beneficiaries after his death, the short term trust presents attractive possibilities in the creation of necessary funds to augment or supplement the general plan of his estate.

So far as gift taxes are concerned, the right of the beneficiary to receive the income of the trust during its term is a gift which may result in gift tax upon creation of the trust.[7] It is estimated that the value of such right to receive income for a period of ten years is close to 30% of the fair market value of the assets of the trust. If by the terms of the trust the income is distributable currently, the annual gift tax exclusion can be used because the gift is of a present interest. If there is a provision for accumulation, even though only in the discretion of the trustee, then, of course, the gift is of a future interest, and the annual exclusion cannot be used. If tax saving happens to be the only alluring feature of a short term trust, then it becomes a matter of mathematical computation of the gift tax, if any, upon the right to receive the income during the term of the trust, and comparing it with the income tax saving of the grantor. Since the gift tax is payable at the inception of the trust, perhaps allowance should be made in the computations for the income, after taxes, which the grantor might have received during the term of the trust, from any amount he pays as gift tax. And a fair presentation of the entire picture would also include allowance for the expense of the administration of such a trust. Account, however, should be taken of the deductability of such expense for tax purposes.

The gift tax exemption, as well as the annual gift tax exclusion, is an important factor in making any comparison between income tax savings and gift tax consequences. The situation should be viewed particularly in the light of a grantor who, for any one of a number of valid reasons, is reluctant to make such an outright transfer by gift of his property as to forfeit entirely any right ever to regain control or possession of it. The short term trust offers about the only possibility whereby a grantor may retain his property through a right to ultimate re-control and re-possession, while at the same time enjoying for a period of years the income tax benefits of reallocating the family income. There is involved, essentially, the problem of just how much a grantor may retain for himself in the way of control and reversionary interest, and at the same time be relieved from income tax liability on the income from the property placed in the trust.

The approach of the Code to this problem is a specific one.

[7] Section 2501 to 2504.

The Code sets forth the various conditions under which the grantor of a short term trust will be taxed on the income from the assets of the trust as though he owned them. The problem of the draftsman is to create a trust which excludes any provisions that may subject the grantor to income tax liability. There is reasonable assurance that if the draftsman can successfully emerge from the obstacle course of Sections 671 to 677, inclusive, of Subpart E, the income of the trust will not be taxable to the grantor by reason of any dominion or control over the trust. Section 671 specifically provides that "No items of a trust shall be included in computing the taxable income and credits of the grantor or of any other person solely on the grounds of his dominion and control over the trust under Section 61 (relating to definition of gross income) or any other provisions of this title, except as specified in this Subpart". The Senate Committee Report[8] states that "the effect of this provision is to insure that taxability of *Clifford* type trust shall be governed solely by this subpart." The Report adds the cautionary statement, however, that this provision does not affect the principles governing the taxability of income to a grantor other than by reason of his dominion and control over the trust. The significance of insuring that the taxability of short term trusts will be governed solely by the provisions of Subpart E is better understood by analyzing the development of the law prior to the 1954 Code.

II. Historical Background

Section 166 of the 1939 Code provided the following:

> Where at any time the power to revest in the grantor title to any part of the corpus of the trust is vested—
>
> (1) in the grantor, either alone or in conjunction with any person not having a substantial adverse interest in the disposition of such part of the corpus or the income therefrom, or
>
> (2) in any person not having a substantial adverse interest in the disposition of such part of the corpus or the income therefrom, then the income of such part of the trust shall be included in computing the net income of the grantor.

Section 167 of the 1939 Code was editorially entitled "Income for Benefit of Grantor," and provided the following:

> (a) Where any part of the income of a trust—
>
> (1) is, or in the discretion of the grantor or of any person not having a substantial adverse interest in the disposition of such part of the income may be, held or accumulated for future distribution to the grantor; or
>
> (2) may, in the discretion of the grantor or of any person not having a substantial adverse interest in the disposition of such

[8] Sen. Rep. No. 1622, 83d Cong., 2d Sess. 365 (1954).

part of the income. be distributed to the grantor; or

(3) is, or in the discretion of the grantor or of any person not having a substantial adverse interest in the disposition of such part of the income may be, applied to the payment of premiums upon policies of insurance on the life of the grantor (except policies of insurance irrevocably payable for the purposes and in the manner specified in section 23 (o), relating to the so-called 'charitable contribution' deduction); then such part of the income of the trust shall be included in computing the net income of the grantor.

(b) As used in this section the term 'in the discretion of the grantor' means 'in the discretion of the grantor, either alone or in conjunction with any person not having a substantial adverse interest in the disposition of the part of the income in question.'

(c) Income of a trust shall not be considered taxable to the grantor under subsection (a) or any other provision of this chapter merely because such income, in the discretion of another person, the trustee, or the grantor acting as trustee or co-trustee, may be applied or distributed for the support or maintenance of a beneficiary whom the grantor is legally obligated to support or maintain, except to the extent that such income is so applied or distributed. In cases where the amounts so applied or distributed are paid out of corpus or out of other than income for the taxable year, such amounts shall be considered paid out of income to the extent of the income of the trust for such taxable year which is not paid, credited, or to be distributed under section 162 and which is not otherwise taxable to the grantor.

The language of the foregoing sections was quite similar in the Revenue Act of 1928, and was almost identical from the 1932 Act down through the 1934 and 1936 Acts.

It is to be noted that under the literal language of Sections 166 and 167, the income was made taxable to the grantor only if there was a power to revoke, or if the income from the trust could, in the grantor's discretion or in the discretion of one not having a substantial adverse interest, be held or accumulated for future distribution to the grantor, or distributed to him, or used to pay premiums upon policies of insurance on the life of the grantor. Nothing was said in Sections 166 and 167 as to the term of the trust. That literal language led to what has been described as a "tax jungle"[9] with respect to the taxation of income of trusts, and it is through that "tax jungle" that the new Code attempts to clear a path.

On February 26, 1940 the United States Supreme Court handed down its decision in the now famous *Clifford* case.[10]

Mr. Clifford had declared himself trustee of a trust of securi-

[9] Ray, The Income Tax on Short Term and Revocable Trusts, 53 Harv. L. Rev. 1322 (1940).

[10] Helvering v. Clifford, 309 U.S. 331 (1940).

ties, all the net income of which was to be paid to his wife. The trust was fixed for a five-year period, except that it would terminate on the death of either Mr. or Mrs. Clifford. On termination, the whole corpus was to go back to Mr. Clifford, but all accrued or undistributed net income was to be paid to his wife. Mr. Clifford had discretion as to how much income would be paid his wife during the five-year term prior to termination. Mr. Clifford retained full power to exercise all voting rights, to sell, exchange, mortgage or pledge any of the securities, including any retained invested income which might become distributable to his wife; to make investments without regard to investment statutes; to collect all income; to compromise all claims; and to hold property in the name of a nominee. Extraordinary dividends, stock dividends and proceeds of subscription rights were to be added to principal. And there was a spendthrift clause against liability for Mrs. Clifford's debts, or anticipation or assignment by her. The case was tried on stipulated facts. It was stipulated that the "tax effects" were not the sole consideration for making the trust, and also that the trust was not designed to relieve the grantor from liability for family and household expenses. A gift tax was paid on the transfer. The Supreme Court of the United States, speaking through Mr. Justice Douglas, upheld the Commissioner's contention that the income of the trust was taxable to the grantor.

It is to be noted that the trust was not revocable under Section 166 and no part of the regular income of the trust was payable to or to be accumulated for the grantor within the language of Section 167. Nevertheless, the Supreme Court found that it could not conclude "as a matter of law" that the grantor "ceased to be the owner of the corpus." The Supreme Court also said that liability under Section 22(a)[11] was not foreclosed by reason of the fact that Congress made specific provision in Section 166[12] for revocable trusts. Section 22(a) of former Codes was the "gross income" section which corresponded to Section 61 of the new Code. The significance of the provision in Section 671 of the new Code that no items of income shall be included in computing the taxable income of the grantor solely on the grounds of his dominion and control over the trust under Section 61 is explained by the following language from the opinion in the *Clifford* case:

> In view of the broad and sweeping language of Section 22(a), a specific provision covering short term trusts might well do no more than carve out of Section 22(a) a defined group of cases to which a rule of thumb would be applied. The failure of Congress to adopt any such rule of thumb for that type of trust must

[11] Int. Rev. Code § 22(a) (1939).

> be taken to do no more than to leave to the triers of fact the initial determination of whether or not on the facts of each case the grantor remains the owner for purposes of Section 22(a).[13]

The provisions of the new Code covering short term trusts, with the reference specifically excluding the taxation to the grantor of income therefrom on grounds of dominion and control over the trust under Section 61, seem to be the rule of thumb suggested in the opinion in the *Clifford* case.

Courts had great difficulty in applying the principles of the *Clifford* case. Justice Douglas had said that "no one fact is normally decisive, but all considerations and circumstances" of the kind mentioned are relevant to the question, and he spoke of the "bundle of rights" which the grantor retained.

So, under the guise of redefining gross income under Section 22(a), in an avowed attempt to resolve the difficulties of applying the principles of the *Clifford* case, the Treasury issued regulations designed to define and specify the significant factors.[14] The Regulations established certain factors which determined if the grantor retained enough control to be taxed on the income from the trust under Section 22(a). The more important factors were:

> (1) If the corpus or income would or could return to the grantor after a relatively short period.
> (2) If the beneficial enjoyment of corpus or income was subject to a power of disposition by the grantor.
> (3) If the corpus or the income was subject to administrative control exercisable primarily for the benefit of the grantor.[15]

These factors are reflected in the provisions of the 1954 Code, which will now be examined.

III. The 1954 Code

In general, there are five hurdles to be cleared in successfully drafting a short term trust so the grantor will not be treated as the substantial owner and will not have the income of the trust taxed to him. The following are the five hurdles:

(1) The reversionary interest of the grantor.[16]
(2) The grantor's power to control beneficial enjoyment.[17]
(3) The extent of the grantor's administrative powers.[18]

[12] Int. Rev. Code § 166 (1939).
[13] Helvering v. Clifford, 309 U.S. 331, 337, 338 (1940).
[14] U.S. Treas. Reg. 118, § 39.22(a)-21.
[15] Ibid.
[16] Section 673.
[17] Section 674.
[18] Section 675.

(4) The grantor's power to revoke.[19]

(5) The extent to which income is for the benefit of the grantor.[20]

A. REVERSIONARY INTERESTS

The trust will not qualify if the grantor has a reversionary interest which "will or may reasonably be expected to take effect in possession or enjoyment within 10 years."[21] Under the old Regulations[22] periods of 10 and 15 years applied under varying conditions. The Code makes no reference to trusts for a 15 year term, and in this respect it is a simplification.

(1) Postponement Rule of Section 673(d)

The Code retains a provision of the Regulations that any postponement of the date for reacquisition of possession or enjoyment of the reversionary interest shall be treated as a new transfer in trust commencing with the date the postponement is effected and terminating with the date prescribed by the postponement.[23] The postponement, however, does not make income includible in the grantor's income if it would not have been includible in his income in the absence of postponement. No tax advantage will be gained, therefore, by any provision of the trust permitting the grantor to extend its term unless the trust is extended for a period of another minimum of 10 years, or for a period continuing during the lifetime of the income beneficiary.

As an example of the application of the postponement rule, the Senate Committee Report[24] gives as an illustration a trust which was originally for a 12 year term. This is 2 years longer than the minimum requirement. If at the end of the ninth year, the term of the trust is extended, so that the trust will have a total term of 14 years, a new 5 year trust will be considered to have been created. However, the income during the first 3 years of the new 5 year trust will not be attributed to the grantor since those first three years constitute the tenth, eleventh and twelfth years of the original 12 year trust.

There may be a decided advantage in having the grantor retain a power to extend the term of the trust. If at the end of 5 years, the grantor has concluded that an original trust for a 10 year term might well remain effective for a total of 15 years,

19 Section 676.
20 Section 677.
21 Section 673(a).
22 U.S. Treas. Reg. 118, § 39.22(a)-21(c)(i), (ii).
23 Section 673(d).
24 Sen. Rep. No. 1622, 83d Cong., 2d Sess. 366 (1954).

he could then extend the trust for a total of 15 years, and would be treated as though he had created a new 10 year trust.

(2) Reversion on Death of Beneficiary Exception

There are two exceptions where the minimum period may be less than 10 years. A trust will qualify if the reversionary interest of the grantor is not to take effect in possession or enjoyment until the death of the person or persons to whom the income of the trust is payable.[25] Thus, a "proviso" for reversion in the event of the death of the income beneficiary, even prior to the expiration of a 10 year term, will not disqualify the trust. According to the Senate Committee Report, the short life expectancy of a beneficiary would not cause the income to be attributable to the grantor.[26] In considering a short term trust for an elderly beneficiary, this is an important point to take into consideration. The same exception would seem to apply in the event of an extension of an established trust, beyond the original minimum 10 year period, for the lifetime of an income beneficiary.

(3) Charitable Beneficiary Exception

The second exception under which the minimum period may become less than 10 years results when the income of the trust is irrevocably payable to certain charitable beneficiaries for a period of at least 2 years commencing at the date of the transfer.[27] Unless the income is irrevocably payable to such charitable beneficiaries for at least two years, the income will be deemed payable to the grantor. The exception will only apply if the charitable beneficiary is of the type defined in Section 170(b) (1) (A) (i) (ii) or (iii) of the Code. These beneficiaries are churches, or a convention or association of churches, tax-exempt educational institutions, and tax-exempt hospitals.

The charitable beneficiary exception is also subject to a further limitation as to its deductibility as a charitable contribution or gift by the grantor. Under Section 170(b) (1) (D) the grantor is not allowed a deduction for any transfer after March 9, 1954 to any trust, if at the time of the transfer the reversionary interest of the grantor exceeds 5% of the value of the property transferred.

It should also be observed that under the charitable beneficiary exception the charitable beneficiary must be "a designated

[25] Section 673(c).
[26] Section 673(c). See also Sen. Rep. No. 1622, 83d Cong., 2d Sess. 367 (1954).
[27] Section 673(b).

beneficiary." The Senate Committee Report[28] states that "the income for the entire period must be paid to the single specifically designated beneficiary." It also emphasizes that the exception will not apply if the trustee has discretion to pay the income to any one or more of several otherwise qualified beneficiaries.

The situations in which the charitable beneficiary exception will apply are likely to be somewhat limited. However, the exception could be applied where a grantor wished to have the income of only a portion of a trust paid for a limited period of time, less than 10 years but at least 2 years, to a tax-exempt educational institution. It must not be overlooked that the income from a portion of a trust will not be taxable to the grantor even though the remainder of the income from the trust will be taxed to him. In drafting any trust agreement with provisions for charitable beneficiaries, it may be important to consider whether full advantage has been taken of this exception to the "10 year minimum" requirement for short term trusts.

Except possibly for the involvements of payments to charitable beneficiaries, it would seem that the first hurdle to overcome in setting up a short term trust is not particularly difficult. It must have a duration of at least 10 years, unless the grantor's reversionary interest takes effect in possession or enjoyment at an earlier date because of the death of the income beneficiaries.

B. POWER TO CONTROL BENEFICIAL ENJOYMENT

The second hurdle which must be overcome in successfully drafting a short term trust relates to the power of the grantor to control beneficial enjoyment. The general rule, as stated in Section 674 of the Code, provides that the grantor shall be treated as the owner of any portion of a trust where the beneficial enjoyment of either corpus or income is subject to a power of disposition by the grantor, or a nonadverse party, or both, without the approval or consent of an adverse party. This general rule is in substantial conformity with Section 167 of the 1939 Code, and Section 39.22(a)-21(b)(3) of the old Regulations in describing one of the factors which renders the income of a trust taxable to the grantor. This general rule was expressed by the Supreme Court in *Helvering v. Horst* in the following language:

> The power to dispose of income is the equivalent of ownership of it. The exercise of that power to procure the payment of income to another is the enjoyment and hence the realization of the income by him who exercises it.[29]

28 Sen. Rep. No. 1622, 83d Cong., 2d Sess. 366 (1954).
29 311 U.S. 112, 118 (1940).

It is to be noted that the new Code specifically provides that if the approval or consent of an adverse party is required before the power of disposition can be exercised by the grantor, or a non-adverse party, or both, then the grantor will not be treated as the owner.[30] This provision suggests that if there is one adverse party whose approval or consent to the disposition is required, even though such adverse party does not himself have any direct power of disposition, his consent will be sufficient to prevent treating the grantor as owner. Although in the Code this provision is included as part of the statement of the general rule, in reality it constitutes one very broad exception. If a grantor is willing to have a provision in the trust requiring the approval or consent of an adverse party before the power of disposition of beneficial enjoyment is exercisable, he will have cleared the second hurdle.

There are many specific execptions in the Code to the general rule. These exceptions fall into three groups:

(1) Power of disposition which may be exercised by any person, including even the grantor himself.

(2) Powers of disposition which may be exercised by so-called "independent trustees," one-half of whom may be related or subordinate parties subservient to the wishes of the grantor.

(3) Powers which may be exercised by a trustee or trustees other than the grantor or the frantor's spouse.

From a familiarity with these exceptions, the draftsman may be able to prepare a trust which will leave a substantial degree of control over the beneficial enjoyment in the grantor or a non-adverse party, or both, or partly or wholly in subservient parties, without the income of the trust being attributed to the grantor.

(1) Section 674(b) Exceptions

(a) Power to Apply Income to Support of a Dependent

The first exception among the powers that any person, including the grantor, may hold, is to apply income to the support of a dependent, except to the extent to which such income is so applied and distributed.[31] This provision corresponds to Section 167(c) of the 1939 Code. Of course, if the income is actually used to support or maintain a beneficiary whom the grantor is legally obligated to support, the grantor is subject to tax. It may be assumed that the burden will be on the grantor who avails himself of such a power at a time when he has a legal obligation to support a beneficiary, to establish that the income was not

30 Section 674(a).
31 Section 675(b)(1); see § 677(b).

applied to the support of such beneficiary. Nevertheless, the exception protects the grantor to the extent that the mere existence of the power will not cause income from the trust to be attributable to the grantor. The circumstance that income from the trust may be used to support or to help support one to whom the grantor owes a legal obligation of support, and that to such extent the income will be taxed to the grantor, is not a serious objection to use of a short term trust. The very existence of this exception, making it possible for the grantor to have such a power without having the trust income taxed to him simply because of such power, is favorable to the use of this type of trust.

(b) Power Affecting Beneficial Enjoyment Only After the Expiration of 10 Year Period

Under the second exception, a power may be exercised by any person, including the grantor, which will affect the beneficial enjoyment of the trust for any period which commences at a time when the grantor would not be treated as owner because his reversionary interest became effective at that time.[32] Thus, there may be a power to dispose or reallocate the income, provided that the power does not become exercisable until the expiration of a 10 year period, or until the death of the income beneficiary or beneficiaries. In the case of trusts where the income is payable to specified charitable beneficiaries for a period of at least 2 years, the power may be exercisable at the end of the 2 year period. This power obviously relates only to trusts which are to continue beyond a 10 year period or beyond the death of the beneficiary or beneficiaries, or, in the case of charitable trusts, beyond the 2 year period. It is logical that, if a reversionary interest in the grantor, effective at such time, will not disqualify the trust, the grantor should have the right to reallocate the income at that time. Of course, if the power becomes currently exercisable, then the income becomes attributable to the grantor. The trust instrument might conceivably be drafted to give the grantor the alternative of a reversionary interest, or the power to dispose of the trust income at the end of the 10 year period, or, in the event of the death of the income beneficiary or beneficiaries. In this connection, it should be noted that one of the rules of Subpart E is that a person shall be considered as having a power even though the exercise of it is subject to a precedent giving of notice, or if it takes effect only upon the expiration of a certain period of time after the exercise of the power.[33]

(c) Power Exercisable Only by Will

32 Section 674(b)(2); see § 673.
33 Section 672(d).

Under the third exception, any person, including the grantor, may reserve the power to dispose of the beneficial enjoyment of the corpus or income by his will.[34] The power must be exercised only by will. This exception conforms with the former Regulations.[35] This exception, however, does not apply to a power to appoint by will the income of the trust, where the income is or may, in the discretion of the grantor or non-adverse party, be accumulated for such disposition. In effect, this exception means that a power to control beneficial enjoyment exercisable by the grantor only by will upon his death will not cause the income to be attributable to the grantor.[36]

(d) Power to Allocate Among Charitable Beneficiaries

A fourth exception would permit the grantor, or any other person, to allocate the corpus or income among charitable beneficiaries.[37] However, this exception is applicable only if the corpus or income is irrevocably payable for a purpose specified in the Code relating to charitable contributions.[38] This provision corresponds to Regulations in effect prior to the Code which permitted the shifting of income or corpus of the trust among different charitable beneficiaries.[39]

(e) Power to Distribute Corpus

A fifth exception relates to a power which may be held by any person, including the grantor, to invade corpus for a beneficiary or beneficiaries, or a class of beneficiaries.[40] It is not necessary that the beneficiary for whom invasion is permitted is an income beneficiary of the trust, provided the power to invade is limited in the trust instrument to a "reasonably definite standard." In this respect, the Code differs substantially from the former Regulations which required a "reasonably definite external standard" which consisted "of needs and circumstances of the beneficiary."[41] But if the corpus is to be invaded under this exception for a current income beneficiary, a standard is not necessary, if the distribution of corpus is chargeable against the

[34] Section 674(b)(3).

[35] U.S. Treas. Reg. 118, § 39.22(a)-21(d)(2)(i).

[36] This observation is subject to the limitation stated in the preceding sentence. A requirement for approval or consent by an adverse party to the accumulation for testamentary disposition by the grantor would remove the limitation stated in the preceding sentence.

[37] Section 674(b)(4).

[38] See § 174(b)(4) relating to the definition of charitable contributions.

[39] U.S. Treas. Reg. 118, § 39.22(a)-21(d)(2)(ii).

[40] Section 674(b)(5).

[41] U.S. Treas. Reg. 118, § 39.22(a)-21(d)(2)(iii). (iv).

proportionate share of corpus held in trust for the payment of income to the beneficiary, as if the corpus constituted a separate trust. The Senate Committee Report[42] explains that this proportionate share limitation is designed to insure that the grantor will not be able to allocate income by a power to invade corpus. The Code further insures that this excepted power will not be used to allocate income by providing that it is inapplicable if any person has a power to add to the beneficiary or beneficiaries or to a class of beneficiaries designated to receive either income or corpus, except where such action is to provide for after-born or after-adopted children. Within the limitations of this exception, therefore, the grantor may have a power to invade corpus, even though, in the case of after-born or after-adopted children, such invasion may result in a reallocation of income. It would seem important in many instances that this excepted power should be preserved in drafting a short term trust.

(f) Power to Withhold Income Temporarily

A sixth important power which may be held by the grantor or any other person is a power temporarily to withhold income.[43] In this respect, the new Code does not differ substantially from the former Regulations. As in the case of the exception last described, this power to withhold income temporarily will not apply if any person has a power to add beneficiaries or a class of beneficiaries, designated to receive income or corpus, except where such action is to provide for after-born or after-adopted children. This exception applies if the income is ultimately paid either to the beneficiary from whom it was withheld, his estate, his appointees, (or persons named as alternate takers in default of appointment), provided the beneficiary's power of appointment does not exclude any person other than the beneficiary, his creditors, his estate, or creditors of his estate.

In the alternative, where there is more than one beneficiary, the exception will apply if, in conjunction with the distribution, upon termination of the trust, of the corpus augmented by such accumulated income, the accumulated income is payable to the current income beneficiaries in shares which have been irrevocably specified in the trust instrument. Accumulated income will be considered to be payable in accordance with the limitations of this exception, where the trust instrument provides that if a beneficiary is not living on a fixed date of distribution, at which date it might reasonably be expected that the beneficiary would

42 Sen. Rep. No. 1622, 83d Cong., 2d Sess. 368 (1954).
43 Section 674(b)(6).

be living, the share of the then deceased beneficiary is to be paid to his appointees, or to one or more alternate takers other than the grantor or the grantor's estate, whose shares have been irrevocably specified. The Senate Committee Report[44] explains that a grantor is not taxed on the income of the trust, even though he can postpone payment of it for a reasonable period of time, provided the time is not so long that the effect of such power is to permit an allocation of income between the income beneficiary and the remainderman. It is to be noted that under this provision the fixed date of distribution must be one which could reasonably be expected to occur during the beneficiary's lifetime. This should not be confused with the rule which provides that a grantor shall not be treated as owner if his reversionary interest is not to take effect in possession or enjoyment until the death of the income beneficiary, even though his death may reasonably be expected to occur prior to the expiration of a 10 year period.[45]

(g) Power to Withhold Income During Disability of a Beneficiary

A seventh power which may be held by the grantor or any other person, in addition to the power described above to withhold income temporarily, is the power to withhold income from a beneficiary during his legal disability, or for any period during which the beneficiary is under 21 years of age.[46] The exception of this power applies even though the accumulated income will not ultimately be paid to the beneficiary from whom it was withheld. However, there is again a limitation upon this exception in that it does not apply if any person has a power to add beneficiaries or a class of beneficiaries designated to receive either income or corpus, except where such action is to provide for after-born or after-adopted children.

(h) Power to Allocate Between Corpus and Income

Still an eighth power which may be held by the grantor or any other person is the power to allocate receipts and disbursements between corpus and income.[47] The Code states this power may be held "even though expressed in broad language." The purpose of this exception, as explained in the Senate Committee Report,[48] is to insure that a power which is normally vested in the trustee for the purpose of conforming to appropriate trust accounting principles, will not, if vested in the grantor as trustee,

[44] Sen. Rep. No. 1622, 83d Cong., 2d Sess. 368 (1954).
[45] Id. at 366.
[46] Section 674(7); see § 2503(c) (gifts to minors).
[47] Section 674(b)(8).
[48] Sen. Rep. No. 1622, 83d Cong., 2d Sess. 369 (1954).

be construed as a power to determine the beneficial enjoyment of income or corpus.

The foregoing specific statutory exceptions to the general rule that a grantor shall be treated as owner of any portion of a trust where the beneficial enjoyment of either corpus or income is subject to a power of disposition by him or a non-adverse party, or both, without the approval or consent of an adverse party, serve to illustrate the many ways in which the grantor may retain some degree of power to control beneficial enjoyment of the trust. Any and all of the excepted powers previously listed may be retained by the grantor without having the income of the trust attributed to him.

(2) Section 674(c) Exceptions

There is a second group of exceptions under which it is likely that the grantor will have some further control, although more indirect, over beneficial enjoyment of the trust. This group of exceptions consists of those powers which may be exercised by so-called "independent trustees."[49] These excepted powers may not be exercised by the grantor, but if there are two more trustees, the powers may be exercised by them even though half, but no more than half, of the trustees are related to the grantor or are subordinate parties who are subservient to the wishes of the grantor.[50] "Related or subordinate parties" are defined by the Code to include any non-adverse party who is the grantor's spouse if living with the grantor, or any one of the following: the grantor's father, mother, issue, brother, sister, employee, or a corporation or any employee of a corporation in which the stock holdings of the grantor and the trust are "significant from the viewpoint of voting control," or an employee of a corporation in which the grantor is an executive.[51] The Code explains that such related or subordinate parties are presumed to be subservient to the grantor in respect of the exercise or non-exercise of the powers conferred on them, unless any such party is shown not to be subservient "by a preponderance of the evidence."[52] The Senate Committee Report[53] comments that, although under the law prior to the Code, a power held by a grantor's spouse, or by any other

[49] The expression "Independent Trustees" is used in the editorial heading of § 674(c) and in the Senate Committee Report, Sen. Rep. No. 1622, 83d Cong., 2d Sess. 369 (1954). The expression does not appear in the text of the subsection.

[50] Section 674(c).

[51] Section 672(c).

[52] Ibid.

[53] Sen. Rep. No. 1622, 83d Cong., 2d Sess. 369 (1954).

related or subordinate party, might be attributed to the grantor solely by reason of the relationship, such a result will follow under the Code only if the party is subservient to the grantor. In view of the presumption of subserviency, however, a grantor would likely encounter considerable difficulty in establishing that any of such suggested parties whom he was desirous to have serve as a trustee was not, in fact, subservient.

The excepted powers which may be exercised by so-called "independent trustees," half of whom may be subordinate, are subject to the limitation which has been noted above in connection with certain of the excepted powers exercisable by the grantor. The exceptions are inapplicable if any person has a power to add to the beneficiary or beneficiaries or to a class of beneficiaries designated to receive either income or corpus, except where such action is to provide for after-born or after-adopted children.

The powers exercisable under the second group of exceptions by so-called "independent trustees" are the following:

> 1. To distribute, apportion, or accumulate income to or for a beneficiary or beneficiaries, or to, for or within a class of beneficiaries; or
> 2. To pay out corpus to or for a beneficiary or beneficiaries or to or for a class of beneficiaries.

With reference to the power to pay out corpus, it is immaterial whether the beneficiaries receiving corpus are income beneficiaries.[54]

The grantor of a short term trust may, therefore, designate his wife as a co-trustee along with one non-subservient trustee, and confer upon the trustees all of the foregoing powers, without having the income of the trust attributable to him. These powers, it will be observed, permit a very high degree of discretion and flexibility. If desired, these trustees may be given discretion to "sprinkle" the income among any group of named beneficiaries, or within a class of beneficiaries. They may have power to accumulate income, and to determine whether it shall be distributed to income beneficiaries or remaindermen. They may have power to pay out corpus at will to any beneficiary or beneficiaries or class of beneficiaries. A grantor may confer all these powers on two co-trustees, one subservient and one not subservient, and still not have the income of the trust attributable to him. Of course, these same trustees might also possess all of the eight excepted powers which are exercisable by "any person," although the grantor, him-

[54] Section 674(c)(2).

self, might retain and exercise those powers in a non-fiduciary capacity.

(3) Section 674(d) Exceptions

There remains a third group of exceptions to the general rule that the grantor shall be treated as owner of any portion of a trust where the beneficial enjoyment of either corpus or income is subject to a power of disposition by him. This exception pertains to power to distribute, apportion or accumulate income when such power is limited by a standard.[55] Such a power is exercisable only by a trustee or trustees, none of whom is the grantor or the grantor's spouse living with the grantor. If the spouse were a co-trustee of two co-trustees authorized to exercise the powers under the second group of exceptions, it would be necessary to deny her any power under the third group of exceptions. However, the powers excepted under this third group of exceptions may be exercised by any one or more trustees, all of whom are related and subordinate, and regardless of their subserviency, except the grantor's spouse living with the grantor, without causing the trust income to be attributable to the grantor. The grantor might, therefore, take advantage of both the second and third group of exceptions, by naming a subordinate co-trustee, other than his wife, to serve with a non-related, non-subordinate trustee. Or the grantor might prefer to forego the power which might be exercisable under the third group of exceptions. Since the broader and more flexible powers seem to exist under the second group of exceptions, it is less likely that the grantor would forego the second group of exceptions to take advantage of the third group. It should be noted, however, that it is only in connection with the powers under the second group of exceptions that any truly independent, non-related, non-subordinate trustee is required. And a grantor who desires to keep the whole trust arrangement strictly "within the family" might prefer to forego any powers which might be available under the second group of exceptions.[56]

Again, it should be noted that there applies also to this third group of exceptions the limitation that this group of exceptions is inapplicable if any person has a power to add to the beneficiary or beneficiaries or to a class of beneficiaries designated to receive the income or corpus, except where such action is to provide for after-born or after-adopted children.[57]

55 Section 674(d).

56 Of course, the "family," in case the grantor wishes to apply the third group of exceptions, could not include the "spouse living with the grantor."

57 Section 674(d).

The power which may be exercised by a trustee or trustees is the power to distribute, apportion or accumulate income to or for a beneficiary or beneficiaries, or to a class of beneficiaries, provided only that such power is limited by a reasonably definite external standard set forth in the trust instrument. This power relates only to income, but it may be provided without regard to whether the conditions with respect to the withholding of income under the sixth and seventh powers under the first group of exceptions are satisfied. The only condition of the power under this exception to the general rule is that the power be limited in the trust instrument by some reasonably definite external standard. The standard prescribed here differs in definition from the standard referred to in the fifth exception of the first group, only in that the standard here prescribed is referred to as one which must be "external."[58]

All of the powers which constitute exceptions to the general rule may be provided in the trust instrument without having the income of the trust attributable to the grantor. The draftsman, however, must be careful that the powers under the second group of exceptions are exercisable by trustees, none of whom is the grantor and not more than half of whom are related or subordinate and subservient; and the powers under the last group may be exercised by trustees none of whom is the grantor or a spouse living with the grantor. While there would probably be no harm in reserving as many of the powers as the trustee qualification provisions permit, it may be that some grantors would not wish to have provision made whereby all the possible powers would be held.

C. ADMINISTRATIVE POWERS

When the two hurdles which pertain to the reversionary interest of the grantor, and to his control over beneficial enjoyment of the trust have been successfully overcome, the draftsman must next avoid retaining administrative powers which may cause the grantor to be treated as owner of the trust or such portion of it over which certain administrative powers exist. These are contained in Section 675.

It is not safe for the draftsman to assume that these provisions relating to administrative powers may be ignored if neither a grantor nor a non-adverse party is trustee, because some administrative powers are prohibited if exercisable by the grantor

[58] The distinction between a "reasonably definite standard" in § 674(b)(5) and a "reasonably definite *external* standard" in 674(d) may be clarified by the new Regulations.

or a non-adverse party regardless of fiduciary capacity, and some are prohibited if exercisable by any person in a non-fiduciary capacity without the consent of a person in a fiduciary capacity. Also, certain of the powers relating to borrowing are prohibited if the trustee is a related or a subordinate trustee subservient to the grantor.

Administrative powers which will cause the grantor to be treated as owner fall into the following four groups:

1. Power to deal for less than adequate and full consideration.
2. Power to borrow from the trust without adequate interest or security.
3. Borrowing of trust funds.
4. General powers of administration.

(1) Power to Deal for Less Than Adequate and Full Consideration

If either the grantor or a non-adverse party, or both, without the approval or consent of an adverse party, has a power which enables the grantor or any other person to purchase, exchange, or otherwise deal with or dispose of corpus or income for less than an adequate consideration in money or money's worth, the grantor will be treated as owner of any portion of the trust subject to such power.[59] It is obvious that such a prohibition is necessary to prevent the grantor or another person from vesting title in himself.

(2) Power to Borrow without Adequate Interest or Security

If either the grantor or a non-adverse party, or both, has a power which would enable the grantor to borrow corpus or income, directly or indirectly without adequate interest or without adequate security, the grantor will be treated as owner.[60] This prohibition, however, does not apply when a trustee other than the grantor himself is authorized under a general lending power to make loans to any person without regard to interest or security. It is to be noted that even the approval or consent of a non-adverse party will not save the power, and that the prohibition is applicable unless a trustee, other than the grantor, has a general lending power to loan without interest or security. Under the Regulations[61] prior to the Code, the trustee, other than the grantor, who might have such general lending power, could not be the

59 Section 675(1).
60 Section 675(2).
61 U.S. Treas. Reg. 118, § 39-22(a)-21(e)(1)(ii).

grantor's spouse, and the general lending power of the trustee could not include power to loan without adequate interest. In these respects, the new Code is slightly less restrictive than the former Regulations. It seems unlikely that the grantor of a short term trust will be particularly concerned about preserving any power for himself to borrow from the trust without adequate interest and adequate security. The prohibition relates only to borrowing by the grantor, and even then the grantor might be able to borrow, without regard to interest or security, under an appropriate general lending power held by a trustee other than the grantor.

(3) Borrowing from the Trust Funds

Subject to certain limitations in the new Code, any loan, directly or indirectly, to a grantor must be repaid, including interest, before the beginning of the taxable year, to avoid having trust income taxable to the grantor.[62] This was an absolute rule under the Regulations[63] prior to the Code. The Code makes this rule less restrictive by providing that it shall not apply to a loan made for adequate interest and adequate security by a trustee other than the grantor and other than a related or subordinate trustee subservient to the grantor. To take advantage of this modification of the former Regulations, there must be a trustee who is neither the grantor nor any related or subordinate trustee subservient to the grantor. If there is such a trustee, it would seem desirable to include in the trust instrument a power to take advantage of the more liberal provisions of the Code.

(4) General Power of Administration

The prohibited general powers of administration relate to the existence of any one or more of certain powers exercisable in a non-fiduciary capacity by any person without the approval or consent of any person in a fiduciary capacity.[64] Neither the grantor nor any other person, individually, may have any one or more of such powers, unless they are conditioned upon the approval or consent of any person in a fiduciary capacity. The powers referred to are: (1) a power to vote or direct the voting of stock or other securities of a corporation in which the holdings of the grantor and the trust are significant from the viewpoint of voting control; (2) a power to control the investment or reinvestment of trust funds, either by direction or veto, to the extent that the trust funds consist of stocks or securities of corporations in which

[62] Section 675(3).
[63] U.S. Treas. Reg. 118, § 39.22(a)-21(c)(1)(iii).
[64] Section 675(4).

the holdings of the grantor and the trust are significant from the viewpoint of voting control; (3) a power to reacquire the trust corpus by substituting other property of an equivalent value. The Senate Committee Report,[65] in commenting upon the possible exercise of powers over investments and voting exercisable in a non-fiduciary capacity, indicates that "non-fiduciary capacity" means in such a manner as to benefit the grantor individually rather than the beneficiaries of the trust. In creating any short term trust in which there is significant inter-relationship between stock or other corporate securities placed in the trust with stock or other securities of the same corporation retained by the grantor, special caution must be exercised to avoid any prohibited power of administration which would cause the grantor to be treated as owner of the stock or other securities placed in trust.

The foregoing are all of the administrative powers which, under the provisions of the Code, will cause the grantor to be treated as owner. While the Code does not require that these administrative powers be expressly prohibited in the trust instrument, it might be desirable to do so.

It will be observed that there are many administrative powers which are not prohibited. These non-prohibited powers include many of the customary administrative provisions common in trust instruments. A power which was before the committees of Congress and apparently was deliberately not included among the rules or prohibitions is a power in the grantor or a related or subordinate party subservient to him to remove a trustee without cause. The thought of including such a provision in the trust instrument suggests the desirability of also including a provision reserving a power in the grantor to release any administrative power or any power to control beneficial enjoyment, the release of which would not increase the grantor's dominion and control over the trust. It would seem that any such release would, in any event, serve only to reduce the grantor's dominion and control, and therefore such a provision would not be objectionable. Such a provision would seem to afford a safeguard against any unanticipated interpretation of the Code embodied in future Regulations, as well as against any amendment which Congress might see fit to enact without adequately protecting short term trusts created in reliance upon the 1954 Code.

D. POWER TO REVOKE

The new Code in Section 676 retains the principle set forth

[65] Sen. Rep. No. 1622, 83d Cong., 2d Sess. 369 (1954).

in Section 166 of the 1939 Code, by providing that, regardless of the other provisions of Subpart E, the grantor shall be treated as owner, where there is a power to revest the title which is exercisable by the grantor or a non-adverse party, or both. Section 166 of the 1939 Code, however, made no specific limitation upon or reference to the time of revocation. It simply declared that where there existed "at any time the power to revest in the grantor" title to any part of the trust, the income from such part of the trust would be taxable to the grantor. The 1954 Code, in Section 676, correlates the provisions concerning the powers to revoke with the provisions concerning reversionary interests in Section 673.

There must not be a power to revoke exercisable during the period that the grantor is not to come into effective possession or enjoyment under the reversionary interests provisions of Section 673. The Code specifically states that the grantor may be treated as owner after the expiration of such period, unless the power to revoke is relinquished.

In addition to careful avoidance of prohibited administrative powers, the draftsman must use caution in the drafting of any power of revocation. In some situations, it might seem the problem could be solved by providing that the trust shall continue for the period of time necessary under the reversionary interests provisions of the Code, and then to include a power to extend the trust for a longer period. However, it must not be overlooked that extension of the trust would constitute a postponement of the date specified for reacquisition, and would be treated as a new transfer in trust commencing with the date on which the postponement is effected.[66] The extended period would have to be for as long a period as the original trust, to avoid having the grantor being treated as owner after the expiration of the original trust period.

E. INCOME FOR BENEFIT OF GRANTOR

If the draftsman has successfully cleared a path through the "jungle" of prohibitions and exceptions which have been discussed above, there remains the problem of making certain that the income of the trust will not be "attributable to the grantor" because of the income being payable to or for his benefit under Section 677 of the Code. The Code provisions on this point are similar to those of Section 167 of the 1939 Code. It may be said that while the "power to revoke" provisions of Section 676 are con-

[66] Section 673(d).

cerned with revesting of corpus in the grantor, Section 677 is concerned with the income being paid to him, or for his benefit.

It is obvious that if the income is distributed to the grantor, it will be taxable to him. Beyond that provision, however, and regardless of whether the grantor will be treated as owner under the provisions of Section 674, the grantor will be treated as owner if the income, without the approval or consent of an adverse party, is, or, in the discretion of the grantor or a non-adverse party, or both, may (1) be held or accumulated for future distribution to the grantor, or (2) applied to the payment of premiums on policies of insurance on the life of the grantor, except policies irrevocably payable for a purpose specified in the Code section pertaining to charitable contributions.[67]

Section 167 of the 1939 Code applied to income which might, in the discretion of the grantor or a non-adverse party, be distributed to the grantor, but by the literal language of Section 167, it did not apply to income which was actually so distributed or required to be distributed. The Senate Committee Report[68] explains that Section 677 is applicable to the mandatory as well as to the discretionary situation.

In applying Section 677 and testing the draft of a trust instrument against its provisions, it must be remembered that under the general rule of Section 674, a grantor will be treated as owner where the beneficial enjoyment of either corpus or income is subject to a power of disposition by the grantor or a non-adverse party, or both, without the approval or consent of an adverse party. The rules of both Section 674 and Section 677 will apply to many situations, and caution must be exercised to avoid causing the income to be attributable to the grantor under either Section.

Special consideration must be given to provisions of the trust instrument relating to capital gains. Capital gains of a trust would normally be added to corpus in trust administration. Since capital gains would be treated as income under the Code, they would seem to be taxable to a grantor who has a reversionary interest in the trust, even though the reversionary interest is not such as otherwise to cause the income of the trust to be attributable to the grantor. The observation is especially significant in connection with the provisions of Section 677 relating to income held or accumulated for future distribution to the grantor, and

67 Section 170(c) (relating to charitable contributions).
68 Sen. Rep. No. 1622, 83d Cong., 2d Sess. 371 (1954).

suggests the possible desirability of including in the trust instrument a provision for the accumulation or distribution of capital gains for the income beneficiary or beneficiaries. In the absence of such a provision, the asset producing the capital gain might be construed to be a portion of the trust from which income is or may be accumulated for the grantor, and even ordinary income from such an asset prior to its sale might be attributed to the grantor, at least in the year of sale.

There is a provision in Section 677 similar to provisions in Section 674[69] and Section 676,[70] whereby the grantor will not be treated as owner because of powers over income or the accumulation of income, which affect income of a period after expiration of a period "such that" the grantor would not be treated as the owner under Section 673, pertaining to reversionary interests, if the power were a reversionary interest. The Code states, however, that after such period the grantor will be treated as owner unless the power is relinquished.

Exception is made in Section 677 to payment of income which may be applied or distributed for the support or maintenance of a beneficiary whom the grantor is legally obligated to support. The grantor will be taxed on such income, but only to the extent that the income is applied or distributed for the support or maintenance of the beneficiary whom the grantor is legally obligated to support. This provision corresponds to Section 167(c) of the 1939 Code, and also to the first exception noted above among the first group of exceptions to the general rule pertaining to Power to Control Beneficial Enjoyment.[71]

F. THE FIVE-YEAR THROWBACK RULE

If the income of a short term trust is to be accumulated, it may, when paid, be subject to the 5 year throwback rule.[72] This circumstance should not deter creation of such a trust. In most instances the application of the rule would not result in specially difficult computations, and, further, there are numerous important exceptions.

Under this rule, if there are accumulations in the year in which the trust is created and later years, which are eventually distributed to a beneficiary, the beneficiary in the year in which he receives the income will be taxed on the income received that

69 Section 674(b)(2).
70 Section 676(b).
71 Sections 674(b)(1), 677(b).
72 Sections 665 to 668.

year and each of the 5 preceding taxable years.[73] The beneficiary, however, will be given credit for the pro rata portion of any tax paid by the trustee on the amounts distributed.[74] It will not be necessary, however, to reopen each of the 5 preceding taxable years and file amended returns. The computation is simply made by treating the amount received as though it were a distribution on the last day of the taxable year in which it was received, computing the tax accordingly, and taking credit for any tax which may have been paid by the trustee upon the distributions on which the beneficiary is then paying tax.[75]

There are various exceptions to the "5 year throwback rule" which will make it inapplicable in a number of circumstances. It does not apply to the following situations:

1. Where the "accumulation distribution" is less than $2,000;[76]
2. Amounts accumulated before the birth of the beneficiary, or before he attains the age of 21;[77]
3. To amounts paid upon a beneficiary's attaining a stated age or ages if the total number of distributions cannot exceed 4, and the period between distributions is not less than 4 years;[78]
4. To amounts paid to meet the "emergency needs" of the beneficiary;[79]
5. A distribution on final termination, if that occurs more than 9 years after the last addition to the trust.[80]

While there may be difficulty in knowing just what requirement will be regarded as an "emergency need," in many situations the distributions can be arranged, without removing all discretion from the trustees, so that the 5 year throwback rule" will not apply.

G. PORTIONS OF TRUST

It is possible to qualify a portion of a trust under the Code sections applicable to short term trusts. The Code uniformly refers to treatment of the grantor as owner of "any portion of a

[73] Section 666.
[74] Section 668(b).
[75] Section 668(a).
[76] Section 665(b).
[77] Section 665(b)(1).
[78] Section 665(b)(3). The Code states that this exception is applicable if, as of January 1, 1954, such distributions are required by the specific terms of the governing instrument. The application of this exception may, therefore, be limited to trust instruments in existence on January 1, 1954. Or the Code may be interpreted to mean that with respect to trust instruments in existence on January 1, 1954, the distributions must be required by specific terms. The committee reports do not elaborate on this point.
[79] Section 665(b)(2).
[80] Section 665(b)(4).

trust." The purpose is to prevent the grantor from being taxable on the entire income from a trust, simply because of some forbidden element of dominion and control, or some reversionary interest in a portion of the trust.

Unless the portion of the trust income which is intentionally to be taxed to the grantor can be stated in percentage, rather than dollars, problems will arise in computing deductions and credits. If the assets of the trust consist of different properties, and if an attempt is made to treat the income from one property or class of property or stocks of one corporation, as property from which income will be taxable to the grantor, and other property as property from which income will not be taxable to the grantor, then a percentage of income plan is not feasible. The general objectives of a short term trust do not contemplate that income from any portion of the trust will be taxable to the grantor, and in the usual situation it will seem desirable to avoid having a portion of the trust qualify, while a portion does not.

H. PERSON OTHER THAN THE GRANTOR TREATED AS SUBSTANTIAL OWNER

The final but very important consideration in creating a short term trust is the possible tax liability which may be imposed on some person, neither the grantor nor the beneficiary, by the measures taken by the grantor in order that the income of the trust will not be taxable to him. Special caution must be taken with respect to any powers which may be granted to the spouse of the grantor, either individually or as trustee. The grantor may find himself including in a joint return as income of his spouse the very income which he sought not to have attributable to himself.

No one other than the grantor will be treated as owner, if the grantor is treated as owner.[81] Two people, therefore, will not be taxed on the same income from a short term trust. However, if any other person has a power exercisable solely by himself to vest corpus or income in himself, or if any other person having previously partially released or otherwise modified such a power, retains such control as would subject the grantor to treatment as owner, then that other person will be taxed as owner.[82]

As an example of the possible tax liability of a spouse, the Senate Committee Report[83] cites the case of a trust established by a husband for the benefit of children, under which his wife may at any time take the trust property. In such a case the income will be taxed to the wife. And even if the wife releases her

[81] Section 678(b).
[82] Section 678(a)(1)(2).
[83] Sen. Rep. No. 1622, 83d Cong., 2d Sess. 371 (1954).

right to take the trust property, but retains any such other control as might make the income taxable to the husband, the income will be taxed to the wife.

Another situation which bears special caution is where a grandparent makes his child trustee or a co-trustee for his minor grandchild. The parent of the grandchild will be taxed on the income of the trust applied for support and maintenance of a person whom he is obligated to support.[84]

The general rule under which a person other than the grantor will be treated as owner as a result of powers possessed by him will not apply to a power which has been renounced or disclaimed "within a reasonable time" after the holder of the power first became aware of its existence.[85] It seems unlikely that this provision will have frequent application, but it could happen that a power of the type and extent here discussed is held by a person not advised of them, was not aware of them, and it is well to be assured that he can renounce them without adverse tax consequences.[86]

Conclusion

Under the new Code, questions pertaining to the duration of a short term trust, and reversionary interests, and also the powers which may be retained by the grantor, are quite clearly answered. If one is willing to leave dominion and control beyond the powers which may be retained individually by the grantor to one or more wholly independent trustees, the creation of a short term trust is not particularly complicated. The drafting becomes more difficult with attempts to avoid independent trustees to the fullest permissible extent, but even then the problems are far from being insurmountable. The clarification of many features of the former Regulations pertaining to short term trusts which is embodied in the new Code clearly warrants careful review of those situations where the use of short term living trusts affords possibilities for income tax saving.

[84] Section 678(c). If the amounts applied or distributed for such support for maintenance are paid out of corpus or out of other than income for the taxable year, such amounts will be deductible from the taxable income of the trust (§ 661(a)(2)), but will be taxed to the holder of the power under § 662.

[85] Section 678(d).

[86] The Code does not seem to state specifically in § 678 where the tax liability would fall in such a situation, but it would seem that the grantor would be treated as owner. Section 671 seems to require that where either the grantor or another person is to be treated as owner, items required to be included in computing the taxable income of either the grantor or another person shall be accounted for by one or the other of them.